Top Ten Issues Facing Insolvency Practitioners Across the Country

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Obtaining a Receiving Order by a Single Creditor

Introduction

Under s. 43(1) of the *Bankruptcy and Insolvency Act*, one or more creditors may file a Petition for a Receiving Order if:

1. the debt owing to the petitioning creditor or creditors amounts to $1,000; and

2. if the debtor has committed an act of bankruptcy within six months next preceding the filing of the petition.

There are many enumerated acts of bankruptcy in the Act, but most creditors will rely on the ground that the debtor has ceased to meet his liabilities generally as they become due.

It is also important to note that s.42(1)(j) must be read in conjunction with s.43(7) of the Act, which requires that a debtor be *unable* to pay liabilities as they become due– not, as opposed to being *able but unwilling*.

There was a time when the question of whether a single creditor could obtain a bankruptcy order was subject to considerable judicial debate, but this is no longer so.

The applicable test

It is now well-settled law that a single creditor can petition for bankruptcy in the circumstances summarized by Henry J. in *Re Holmes*:[1]

a) The creditor is the only creditor of the debtor, and the debtor has failed to meet repeated demands of the creditor; in these circumstances he should not be

[1] (1975), 9 O.R. (2d) 240 at page 242

denied the benefits of the Bankruptcy Act by reason only of his unique character; or

b) The creditor is a significant creditor and there are special circumstances such as fraud on the part of the debtor which make it imperative that the processes of the Bankruptcy Act be set in motion immediately for the protection of the whole class of creditors; or

c) The debtor admits he is unable to pay his creditors generally, although they and the obligations are not identified.

The appellate courts of British Columbia, Manitoba, New Brunswick, Nova Scotia, Ontario, and Saskatchewan have each respectively endorsed these principles.

On the whole, this test is sensible. The Act is intended to be practical rather than legalistic. To echo the first branch of the Holmes test, this goal would be stifled if a single creditor were denied access to the Act. Perhaps even this reasoning is overkill; a straightforward, literal interpretation may suffice. After all, s.42(1)(j) of the Act says that an act of bankruptcy is committed "[i]f the debtor ceases to meet his liabilities generally as they become due". Assume two different liabilities – a mortgage and a line of credit – are owed by the debtor to the petitioning creditor, who also happens to be the debtor's only creditor, there is no principled reason why the single creditor could not rely on these debts in support of a Receiving Order.

"Special Circumstances"

Most of the cases involve debates over what constitutes "special circumstances", being the criterion that appears in the second branch of the Holmes test. The following are among those that have been found to so qualify:

a) Environmental concerns if taking possession of secured property would expose the creditor to potential environmental liabilities and if the concerns relate to current operations– the trustee in bankruptcy is protected against potential environmental liabilities and is therefore in a better position over the property for liquidation;[2]

[2] *Re Giusto*, [1994] O.J. No. 934 (Ont. Gen. Div.)

b) Concerns over the petitioned company transferring out substantial monies to other associated companies in light of evidence of an undertaking that this activity not occur;[3]

c) The transfer of substantial assets in the context of a combination of low initial consideration, a deferred payment schedule (20 years), and no interest, at a time of substantial default to the petitioning creditor.[4]

The issue of environmental concerns raises an interesting issue. In light of the other facts in *Re Giusto*, such as the fact that the debtor had been given repeated demands for payment from the petitioning creditor, the first branch of the Holmes test was satisfied notwithstanding the environmental concerns. As such, the comments about environmental concerns could be taken as mere *obiter*.

Second, an environmental study of the debtor's land reported *current* environmental concerns relating to *existing* operations. In other words, there was a potential environmental problem that was getting bigger. In the court's words, "the court should permit the process to proceed immediately for the protection of the bank and any other creditors even if they are not petitioning creditors".[5]

Third, although the court commented that the trustee in bankruptcy is protected against potential environmental liabilities and is therefore in a better position than a creditor, this reasoning is problematic. It does not seem to engage the Holmes test criteria since this factor alone does not involve any need for urgency or immediate action. Then again, there is no reason why the test summarized in Holmes cannot be expanded, but the issue of trustee immunity to environmental liabilities does not fall within the reasoning behind the existing Holmes test.

The situations relating to wrongful conduct by the debtor are much easier to justify. It is neither surprising nor inappropriate that such facts have been found to constitute the requisite special circumstances.

It is also instructive to review some situations where the alleged existence of special circumstances was rejected.

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[3] *Guarantee Co. of North America v. RCL Operators Ltd.*, [1994] N.B.J. No. 419 (N.B.C.A.)

[4] *Re Springridge Farms Ltd.*, 79 D.L.R. (4th) 88 (Sask. C.A.)

[5] *Re Guisto*, supra, para. 26

Does an unsatisfied judgment constitute the requisite "special circumstances"? A unanimous Ontario Court of Appeal rejected the suggestion that an unsatisfied judgment *necessarily* constitutes such circumstances. Instead, the court ruled that a judgment *may* so qualify, but regard must he given to numerous criteria, including: the size of the judgment; how long it has been outstanding; why it has been outstanding; whether there has been a judgment debtor examination; the results of any such judgment debtor examination, and what steps the judgment creditor has taken to determine whether there are other creditors and the results of those inquiries.[6]

The existence of special circumstances was also rejected in *Toronto Dominion Bank v.Langille*.[7] On the issue of special circumstances, there was considerable argument over whether the transfer of a fluid milk quota beyond the grasp of the petitioning bank was an act of bankruptcy. The majority of the Nova Scotia Court of Appeal found that it was not a transfer with the intent to defraud, defeat or delay their creditors since the "transfer was made because the *Toronto Dominion Bank v. Langille* felt that the bank had wrongly demanded an assignment of the quota which they had continually refused to give": supra, at para 16. Note the very fine line between the transfer of assets in *Toronto Dominion Bank v. Langille* and the cases discussed earlier (i.e. *Guarantee Co.* and *Springridge*).

Subsidiary Issues

What is the meaning of a "demand" within the meaning of the *Bankruptcy Act*? A unanimous Saskatchewan Court of Appeal held that it is "a formal request which puts the [debtor] on notice that the [petitioning creditor] may thereafter take the appropriate action pursuant to the provisions of the *Bankruptcy Act*".[8] The court firmly rejected the notion that a request for payment made during the course of negotiations for settlement constitutes a "demand" within the meaning of the Act. However, the court's reasoning appears to be influenced by the fact that the Saskatchewan *Farm Security Act* – which provides for mandatory mediation between a creditor and a farmer – was engaged in the fact scenario before the court.

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[6] *Valente v. Fancsy Estate*, 70 O.R. (3d) 31 at para. 16

[7] (1983), 45 C.B.R. (N.S.) 49

[8] *Re Springridge Farms Ltd.* (1991), 79 D.L.R. (4th) 88

Where multiple creditors exist

Where there is only a single petitioning creditor, but the debtor has numerous creditors, the petitioner has an uphill battle for in these situations the creditor must not only prove the existence of "special circumstances" as per the Holmes test, but they must also show that they are not simply using the Act as a sort of collection scheme. The petitioner's task is even tougher when the other creditors *are* getting paid and the petitioner is the sole creditor who is not. This fact situation arose in *Toronto Dominion Bank v. Langille*, *supra*. In that case, a majority of the Nova Scotia Court of Appeal surveyed the previous jurisprudence on the topic and their decision seemed to ultimately turn on the words of Henry J. in *Re Holmes*: "[T]he petitioning creditor must strictly establish that...the debtor 'ceases to meet his liabilities generally as they become due'...by the existence of other creditors, or of one of the special circumstances...." *Toronto Dominion Bank v. Langille*, *supra*, at para. 21. Since TD Bank was the only creditor not being paid and in the absence of special circumstances similar to "fraud", the bank failed in obtaining a bankruptcy order.

Summary

The law on single creditors petitioning for bankruptcy can be summarized as follows:

- In all cases, the petitioner must show that the debtor is *unable* to meet the liabilities generally as they become due – not simply that the debtor is able but unwilling;

- If the petitioner is the debtor's sole creditor, they must show that repeated demands for payment have been given;

- If the petitioner is the debtor's significant debtor, they must show that repeated demands have been given and that "special circumstances" exist;

- "Special circumstances" include fraud, suspicious transactions affecting the debtor's assets, current environmental concerns, or similar facts involving situations of urgency to protect the interests of the debtor's creditors as a class;

- Environmental concerns may qualify as "special circumstances" – under the existing Holmes test, they would have to have an element of urgency or immediacy to them, but courts have also allowed claims where the petitioning creditor was deterred from seizing assets directly for fear of taking on environmental liabilities that a trustee in bankruptcy would be immune from;

- If the petitioner is a significant creditor of the debtor, but the debtor has paid the other creditors, the creditor must show "special circumstances" and the

threshold for doing so may be higher than if there were other unpaid creditors, due to the courts' reluctance to have the Act operate as a collection scheme for disputes;

- To constitute a "demand", the request for payment should be formal enough to communicate that non-payment may result in bankruptcy proceedings;

- If a debtor admits that they cannot pay their liabilities generally, a single creditor will succeed in the bankruptcy petition.

Payments Made by a Bankrupt

Current Services vs. Preferential

Expenditures made by insolvent persons are closely scrutinized by their trustees. A common issue that arises is whether a given payment was for current services, or as a preferential payment to a creditor. If it is found to be the latter, it is deemed "fraudulent" by s.95 of the *Bankruptcy and Insolvency Act*, R.S. 1985, c. B-3, which reads as follows:

> **95.** (1) Every conveyance or transfer of property or charge thereon made, every payment made, every obligation incurred and every judicial proceeding taken or suffered by any insolvent person in favour of any creditor or of any person in trust for any creditor with a view to giving that creditor a preference over the other creditors is, where it is made, incurred, taken or suffered within the period beginning on the day that is three months before the date of the initial bankruptcy event and ending on the date the insolvent person became bankrupt, both dates included, deemed fraudulent and void as against the trustee in the bankruptcy.
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> (2) Where any conveyance, transfer, charge, payment, obligation or judicial proceeding mentioned in subsection (1) has the effect of giving any creditor a preference over other creditors, or over any one or more of them, it shall be presumed, in the absence of evidence to the contrary, to have been made, incurred, taken, paid or suffered with a view to giving the creditor a preference over other creditors, whether or not it was made voluntarily or under pressure and evidence of pressure shall not be admissible to support the transaction.
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> Definitions (3) In this section,
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> "creditor" includes a surety or guarantor for the debt due to the creditor;

> "insolvent person" means a person who is not bankrupt and who resides or carries on business in Canada, whose liabilities to creditors provable as claims under this Act amount to one thousand dollars
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> a) who is for any reason unable to meet his obligations as they generally become due, or
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> b) who has ceased paying his current obligations in the ordinary course of business as they generally become due, or
>
> c) the aggregate of whose property is not, at a fair valuation, sufficient, or if disposed of at a fairly conducted sale under legal process, would not be sufficient to enable payment of all his obligations, due and accruing due.

The initial onus is on the Trustee to raise a presumption of fraudulent preference. In order to do so, the Trustee must prove the following:[9]

a) the debtor was insolvent at the time the transaction occurred;

b) the transaction was made within three months before the date of the bankruptcy; and

c) the effect of the transaction was that a creditor received a preference.

Once the trustee has established the foregoing three criteria, the onus shifts to the creditor, who must prove on the balance of probabilities that the bankrupt did not intend to give them a preference. In *Hudson v. Benallack*,[10] the Court stated in clear terms that it is only the *bankrupt*'s intention that is relevant to this assessment. Whether the creditor was aware of the bankrupt's financial affairs, or of the payment being preferential, or of anything, for that matter, is irrelevant. The test is subjective.

An interesting implication of this one-sided test of intent appears in *Catalena Productions Inc. (Trustee of) v. A Law Firm*.[11] The law firm was being sued with regards to two payments it "received" from the bankrupt. In both payments, the law firm simply retained a portion of trust funds that arose from a real estate transaction. However, of the two payments, the debtor had disputed one and the Court found that this payment was not a preference, but that the other payment, to which the debtor had acquiesced, was fraudulent (but note that the law

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[9] *Slaunwhite & Songs Developments Ltd. (Trustee of) v. Sumner Holdings Ltd*, [1982] N.S.J. No. 75.

[10] [1976] 2 S.C.R. 168

[11] [1983] 6 W.W.R. 448

firm was found to have a "conflict of interest" because they failed to disclose information about payment from the bankrupt, and accordingly the funds were returned to the Trustee).

How have the courts gone about assessing the debtor's "intent"? One key factor appears to be whether the debtor has shown other attempts at staying in business besides the one payment to the defendant creditor. The absence of this factor was fatal in *L.R.B. Excavation Ltee (Trustee of) v. Hubert Insurance Ltd.*[12] where the debtor had paid a sum to its insurance company for premiums, and because "he wanted to continue operating the company and was afraid the insurance policies would be cancelled for non-payment of premiums..." which would "put an end to his company's operations."

This can be contrasted with the case of *All-Temp Trailer Service Ltd. (Trustee of) v. Jones & MacLean*[13] – a case that insolvency lawyers have surely embraced with open arms. The issue in the case was whether payments the bankrupt made to its solicitors for services relating to the bankrupt's financial problems were void as a fraudulent preference. The Court stressed at paragraph 17 that "[n]ot all commercial transactions result in a debtor-creditor relationship", only those that do fall within the ambit of s. 95 of the *Act*. With regards to the retainer, Rice J.A. (with which Hoyt C.J.N.B. concurred) stated at paragraph 21 that "[h]aving deposited a cash sum to be applied towards the payment of the services, I can only conclude that the funds were to be applied and earmarked for the payment of those services as they were being provided."

Ryan J.A. decided the case on different reasons, namely, at paragraph 36, that "[t]he retainer was not given for the purpose of giving the law firm a preference. *It was given for the very legitimate purpose of retaining professional advice to avoid bankruptcy* and its stigma, and subsequently for professional services for the orderly disposition of company assets." (emphasis added)

In *Slaunwhite & Songs Developments Ltd. (Trustee of) v. Sumner Holdings Ltd* (supra), the presumption of fraudulent preference raised by the Trustee was successfully rebutted because the court accepted that the debtor had made the payment "for the purpose of enabling the company to stay in business" (at paragraph 27). The reader will note that this case is difficult to reconcile with *LRB v. Hubert Insurance* discussed *supra*.

Another interesting aspect of this area of the law is the difference between "preference in fact" and "preference in law" – only the latter violates s.95 of the Act. For instance, in *Re Clarke*, [1999] A.J. NO. 595, the debtor has made payments to one credit card company in preference

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[12] [1982] N.B.J. no. 49

[13] [1994] N.B.J. No. 159 (C.A.)

to another company, which preference was motivated by her desire to reduce the outstanding balance on the account with higher interest charges. This was preference in fact, but not in law, and accordingly the payments were not void as being a fraudulent preference.

Summary

The initial onus rests on the Trustee to prove that (1) the debtor was insolvent at the time of the transaction; (2) the transaction was within 3 months of the debtor's bankruptcy; and (3) that the *effect* of the payment was to give the creditor a preference. Once these have been proven, the creditor must disprove, on a balance of probabilities, that the debtor did not intend to give it a preference.

However, not all commercial transactions result in a creditor-debtor relationship to which s.95 applies. The *All-Temp*, decided in the NBCA, is promising for creditors who are involved in providing services related to the bankruptcy/insolvency.

Whether payments made to suppliers for the purpose of "keeping the company in business to avoid bankruptcy" can rebut the presumption of fraudulent preference is a very grey area of the law. On the one hand, it appears to be a valid and worthwhile cause that deserves deference. On the other hand, it may provide too easy of a vehicle for otherwise fraudulent preferences to be disguised as valid transactions.

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